



## **SMALL BUSINESS ADMINISTRATION**

### **13 CFR Parts 120 and 121**

#### **RIN 3245-AH87**

#### **Affiliation and Lending Criteria for the SBA Business Loan Programs**

**AGENCY:** U.S. Small Business Administration.

**ACTION:** Final rule.

**SUMMARY:** The U.S. Small Business Administration (SBA or Agency) is amending various regulations governing SBA's 7(a) Loan Program and 504 Loan Program, including regulations on use of proceeds for partial changes of ownership, lending criteria, loan conditions, reconsiderations, and affiliation standards, to expand access to capital to small businesses and drive economic recovery. The amendments to affiliation standards will also apply to the Microloan Program, Intermediary Lending Pilot Program, Surety Bond Guarantee Program, and the Disaster Loan programs (except for the COVID Economic Injury Disaster Loan (EIDL) Disaster Loan Program).

**DATES:** This rule is effective [INSERT DATE 30 DAYS AFTER PUBLICATION IN THE FEDERAL REGISTER].

**FOR FURTHER INFORMATION CONTACT:** Dianna Seaborn, Director, Office of Financial Assistance, Office of Capital Access, Small Business Administration, at (202) 205-3645 or [Dianna.Seaborn@sba.gov](mailto:Dianna.Seaborn@sba.gov). The phone number above may also be reached by individuals who are deaf or hard of hearing, or who have speech disabilities, through the Federal Communications Commission's TTY-Based Telecommunications Relay Service teletype service at 711.

#### **SUPPLEMENTARY INFORMATION:**

##### **I. Background Information**

The mission of SBA is to “aid, counsel, assist and protect the interests of small business concerns in order to preserve free competitive enterprise and to maintain and strengthen the overall economy of our nation.” 15 U.S.C. 631(a). SBA accomplishes this mission, in part, through Capital Access programs that bridge the financing gap in the private market to help small businesses start and grow; and help businesses of all sizes to recover from disasters. 15 U.S.C. 636(a) and (b). SBA determined that changing conditions in the American economy, technological developments, and a constantly evolving small business community necessitate the need to revise regulations to improve program efficiency and the customer experience for the 7(a) and 504 Loan Programs. Additionally, SBA determined that revisions for similar purposes to SBA regulations on affiliation determinations should also apply to the Microloan Program, the Intermediary Lending Pilot Program (ILP Program), the Surety Bond Guarantee Program (SBG Program), and the Business Disaster Loan Programs, which consist of Physical Disaster Business Loans, Economic Injury Disaster Loans (EIDL), and Military Reservist Economic Injury Disaster Loans (MREIDL) (but do not include COVID EIDL Disaster Loans).

Accordingly, on October 26, 2022, SBA published a notice of proposed rulemaking with a request for comments in the *Federal Register* (87 FR 64724) to streamline and modernize the 7(a) and 504 Loan Program regulations setting forth use of proceeds regarding partial changes of ownership, lending criteria, hazard insurance requirements, and reconsiderations. Specifically, SBA is amending 13 CFR 120.130 on “Restrictions on uses of proceeds”; 13 CFR 120.150 on “What are SBA’s lending criteria?”; 13 CFR 120.160 on “Loan conditions”; 13 CFR 120.193 on “Reconsideration after denial”; 13 CFR 120.202 on “Restrictions on loans for changes of ownership”.

Regarding 13 CFR 120.130 on “Restrictions on uses of proceeds” and 13 CFR 120.202 “Restrictions on loans for changes of ownership” except for where an employee

stock ownership plan or Qualified Employee Trust (ESOP) purchases a controlling interest (51 percent or more) in the employer small business from the current owner(s), SBA's current regulations do not permit 7(a) loan proceeds to be used for partial changes of ownership. Therefore, SBA is amending restrictions on borrowers using 7(a) loan proceeds to effect partial changes of ownership to assist small businesses and to expand pathways to ownership.

Regarding 13 CFR 120.150 on "What are SBA's lending criteria?" SBA stated that streamlining and modernizing regulations on lending criteria and loan conditions for its 7(a) and 504 Loan Programs can better position the Agency and participating lenders to meet the needs of America's small businesses, create jobs, assist with recovery from the COVID-19 pandemic, and grow the economy, fueling American entrepreneurship. SBA is amending this section to provide capital in the form of 7(a) and 504 loans to more small businesses.

Regarding 13 CFR 120.193 on "Reconsideration after denial" SBA is amending the process for reconsideration after denial of a loan application or loan modification request in its 7(a) and 504 Loan Programs to provide the Director, Office of Financial Assistance, with the authority to delegate decision making to designees. SBA is also amending the regulation to allow the Administrator, solely within their discretion, to review these matters and make the final agency decision on reconsideration. Such discretionary authority of the Administrator would not create additional rights of appeal on the part of an applicant not otherwise specified in SBA regulations.

Further, SBA is simplifying 13 CFR 121.301, which sets forth the principles for determining affiliation in the 7(a) Loan Program, 504 Loan Program, Microloan Program, ILP Program, SBG Program, and Business Disaster Loan Programs (except for the COVID EIDL Disaster Loan Program). Specifically, SBA is removing the provisions on affiliation arising from management and control, franchise or license agreements, and

identity of interest and to streamline affiliation determinations based on ownership. SBA is streamlining the provisions on affiliation to remove paragraph (f)(5), affiliation based on franchise and license agreements. Because SBA is removing the principle of control of one entity over another from its affiliation consideration, this paragraph is no longer needed. Upon the effective date of this rule, SBA will no longer publish the SBA Franchise Directory. This final rule redefines affiliation for all these programs, thereby simplifying affiliation determinations.

## II. Summary of Comments

SBA received 146 comments on the proposed rule. Of these, 51 comments were from lenders, 21 were from cooperatives, 19 were from individuals who were making personal comments, 13 were from nonprofit organizations that were not lenders or trade groups, 11 were from trade groups, eight were from individuals supporting a trade group or other entity's comments, and 23 were anonymous or did not indicate an organization type.

SBA received a total of 14 comments from six trade groups, six lenders or employees of lenders, and two comments from individuals or businesses objecting to the confluence of the proposed changes in the notice of proposed rulemaking in the *Federal Register* (87 FR 64724 October 26, 2022) to streamline and modernize the 7(a) and 504 Loan Program regulations, the notice of proposed rulemaking published in the *Federal Register* (87 FR 66964 November 7, 2022) to lift the moratorium on licensing new Small Business Lending Companies (SBLCs), to add a new type of entity called a Mission-Based SBLC, and to remove the requirement for a Loan Authorization (SBLC Proposed Rule), and SBA's announcement of an upcoming revision to the Standard Operating Procedures (SOP) 50 10, Lender and Development Company Loan Programs. The comments stated the confluence of these revisions are problematic as proposed because SBA would immediately invite additional non-federally regulated entities to participate

as 7(a) Lenders without first testing whether the streamlining of provisions such as lending criteria and hazard insurance will have an adverse effect on SBA's loan portfolio. One trade group requested the Administrator to temporarily withdraw both proposed rules.

SBA received 54 comments requesting changes to SBA's regulations and procedures for loans to ESOPs and cooperatives. Many of these comments were based on a template letter that stated for loans to cooperatives, SBA should remove SBA's regulation at § 120.160, paragraph (a), which requires personal guarantees from holders of at least 20 percent ownership interest in the small business concern that receives SBA funding. SBA requires a personal guaranty from owners of 20 percent or more of the borrower as a prudent and reasonable risk mitigation measure. SBA applies the requirements for personal guarantees at § 120.160 to all SBA business loans unless otherwise prohibited by law. Because the Internal Revenue Service (IRS) prohibits ESOPs from guarantying a loan, SBA does not require ESOPs to provide guarantees for SBA loans. There is no legal prohibition on requiring a guaranty of repayment from a business organized as a cooperative. Further, eliminating the requirement for a guaranty of repayment for loans to cooperatives would unfairly transfer the burden of the increased risk from these loans to the rest of the SBA portfolio. Comments also requested that SBA eliminate the requirement for sellers to guaranty a loan made to a cooperative that is buying a business from the seller. The only time SBA requires a seller to provide a repayment guaranty is in a change of ownership when the seller will retain an ownership interest in the business after the sale. Under SBA's current rules, it is only possible for a seller to retain ownership in a business after a change of ownership when the purchaser is an ESOP or equivalent trust. SBA requires a personal guaranty from a seller that retains an ownership interest in the business after a change of ownership to prevent unjust enrichment to the selling owner such as when the selling owner personally benefits from

the SBA loan proceeds and retains ownership in the business without providing any repayment guaranty on the loan. Changes to the personal guaranty requirements at 120.160 advanced by these comments are outside the scope of the changes in the proposed rule and will not be addressed in this final rule. Comments also requested that SBA reduce equity or equity injection requirements for loans to ESOPs and cooperatives. The proposed revisions to the equity requirements in § 120.150, “What are SBA’s lending criteria?” are sufficient to provide SBA and lenders with the flexibility to underwrite loans to ESOPs and cooperatives in a reasonable and prudent manner, including determining what equity or equity injection requirements should be placed on a loan for risk mitigation. SBA will provide further guidance in its Loan Program Requirements.

SBA has addressed in detail the comments received on specific proposed regulatory changes within the section-by-section analysis below.

### III. Section-by-Section Analysis

#### *Section 120.130 – Restrictions on uses of proceeds.*

Current § 120.130 details restrictions on uses of loan proceeds. Paragraph (g) refers to § 120.202 regarding restrictions on borrowers from using loan proceeds to purchase a portion of a business or another owner’s interest in a business. Because SBA is revising § 120.202, as described below, to allow 7(a) loan proceeds to fund partial changes of ownership, SBA is also revising § 120.130, paragraph (g), to remove the reference to section 120.202 so that 7(a) loan proceeds may be used for partial changes of ownership. Because the revisions to § 120.130 are being made to support the revisions at § 120.202 that will allow partial changes of ownership, the comments on this section are discussed below in the section-by-section analysis for § 120.202.

Several comments stated that § 120.130(a) currently prohibits payments, distributions, or loans to associates (as defined in § 120.10) of the applicant (except for

ordinary compensation for services rendered), and this paragraph would also need to be modified to permit payments, distributions, or loans to associates of the applicant to facilitate partial changes of ownership. SBA had already addressed the prohibition in § 120.130(a) that prohibits payments, distributions, or loans to associates of the applicant by the proposed revision to § 120.202, which, as proposed, would state:

“Notwithstanding § 120.130(a), a borrower may use 7(a) loan proceeds to purchase a portion of or the entirety of an owner’s interest in a business, or a partial or full purchase of a business itself.” However, the comments infer that there would be some confusion in interpreting the proposed revisions to §§ 120.130 and 120.202 regarding restrictions on uses of proceeds for partial changes of ownership. Accordingly, SBA is revising § 120.130, paragraph (a) for clarity to state that payments, distributions, or loans to associates of the applicant are restricted except for ordinary compensation for services rendered or to facilitate changes of ownership in accordance with § 120.202. SBA is revising § 120.202 as stated below. SBA is also revising § 120.130(g) to remove the reference to section 120.202 to permit partial changes of ownership to assist small businesses and provide a path of ownership for employees.

*Section 120.150—What are SBA’s lending criteria?*

Current § 120.150 states that SBA’s lending criteria for 7(a) and 504 loans requires that the applicant (including the Operating Company) must be creditworthy; loans must be so sound as to reasonably assure repayment; and SBA will consider nine specific factors in its lending criteria. The factors consist of: (a) Character, reputation, and credit history of the applicant (and the Operating Company, if applicable), its associates, and guarantors; (b) Experience and depth of management; (c) Strength of the business; (d) Past earnings, projected cash flow, and future prospects; (e) Ability to repay the loan with earnings from the business; (f) Sufficient invested equity to operate on a sound financial basis; (g) Potential for long-term success; (h) Nature and value of

collateral (although inadequate collateral will not be the sole reason for denial of a loan request); and (i) The effect any affiliates (as defined in part 121 of this chapter) may have on the ultimate repayment ability of the applicant. SBA is revising this regulation as discussed below. In revising § 120.150, SBA retains the requirement that the applicant (including an Operating Company) must be creditworthy and that loans must be so sound as to reasonably assure repayment, consistent with section 7(a)(6) of the Small Business Act.

SBA is streamlining its lending criteria by reducing the number of factors that are required to be applied in determining creditworthiness and reasonable assurance of repayment. SBA is revising this section to state that, as part of considering whether the applicant (including an Operating Company) is creditworthy and the loan is so sound as to reasonably assure repayment, SBA, Lenders (as defined in § 120.10), and Certified Development Companies (CDC) may consider (as applicable) any of the three specific criteria individually or any combination of the three specific criteria when approving loans: (a) The credit score or credit history of the applicant (and the Operating Company, if applicable), its associates and any guarantors; (b) The earnings or cashflow of the applicant; or (c) Where applicable, any equity or collateral of the applicant.

First, SBA is incorporating into the regulation a new requirement that SBA Lenders must use appropriate and prudent generally acceptable commercial credit analysis processes and procedures consistent with those used for their similarly-sized, non-SBA guaranteed commercial loans. In using such appropriate and prudent processes and procedures, SBA Lenders will be required to underwrite SBA loans in the same manner in which the SBA Lenders underwrite their similarly-sized, non-SBA guaranteed commercial loans.

SBA received 48 comments on this amendment. Twenty-seven of the comments supported the proposed changes as-is or that expressed support and requested

modifications; twenty comments expressed opposition; and one comment sought clarification on the changes without offering a position of support or opposition. Some comments, including one from a trade group, expressed concern that, where SBA requires SBA Lenders to underwrite SBA loans in the same manner in which they underwrite their similarly-sized, non-SBA guaranteed loans, SBA Supervised Lenders and CDCs will not have processes and procedures for underwriting non-SBA guaranteed commercial loans because they only make SBA guaranteed loans. The trade group expressed concern that, if the SBLC Proposed Rule is adopted, the number of SBA Supervised Lenders could be greatly expanded at the same time SBA's requirements for a consistent underwriting framework are abandoned. The trade group expressed concern that SBA Supervised Lenders will be able to decide individual loan applications based completely on their own credit policies and practices that would result in the deterioration of the 7(a) loan portfolio's credit quality and adverse impacts to borrower and 7(a) Lender fees while possibly creating the need for Congress to provide appropriations to cover the increased costs of 7(a) loans. Other comments argued that allowing SBA Supervised Lenders and CDCs that only make SBA-guaranteed loans to set their own policies would create an unfair playing field for these lenders over federally-regulated lenders that must apply credit policies in accordance with their federal regulator's standards. SBA Supervised Lenders and CDCs (as defined in 13 CFR 120.10) that do not make non-SBA guaranteed commercial loans will continue as they do now, to submit their credit policies, including credit scoring models, for review by SBA prior to approval to participate in the program(s), during lender oversight and review processes, when proposing any changes to their policies or practices, in accordance with Loan Program Requirements as defined in 13 CFR part 120. SBA may at its discretion review the policies of any participating SBA Lender to ensure appropriate use of the policies and procedures.

Some comments argued against the elimination of the review of “character and reputation” in lending criteria, fearing past bankruptcies will not be adequately captured in underwriting, or that people with a past background of criminal behavior are likely to lapse back into criminal activities that could place the loan repayment at risk. Some comments expressed concern that an error by a lender or credit reporting agency could unfairly negatively impact an individual’s or entity’s credit history, and without consideration of character or reputation, the individual or entity may be denied a loan that they would have otherwise received. For SBA, “character” is used to determine whether an individual may have past criminal history or activities that may pose a risk to repayment ability. However, the lending industry uses character and credit history interchangeably, which creates confusion as to which factor is more relevant. In order to provide an objective rationale for credit review, the credit history has clearer meaning and relevance in loan underwriting. The use of reputational risk is subject to individual interpretation where an objective measure such as credit history, as a component of loan underwriting and credit review results in less variability. SBA’s regulations set a minimum standard, beyond which SBA Lenders may take additional steps in underwriting a loan, including considering mitigating factors for negative credit histories, such as a reporting error by a credit reporting agency. SBA currently has a regulation at § 120.110 that addresses criminal background. Additionally, SBA Lenders may continue to make their own credit decisions based on the criminal background of an applicant and its associates.

Some comments, including one from a trade group, opposed allowing lenders to use their own business credit scoring models for 7(a) loans of all sizes. However, SBA will only permit those business credit scoring models that are predictive of the borrower’s ability to repay the loan at the proposed loan sizes, and SBA Lenders may continue to underwrite loans without using credit scoring models. Additionally, SBA will provide

guidance in Loan Program Requirements stating the maximum loan sizes that may be underwritten using credit scoring and what other credit factors must be addressed in addition to documenting a satisfactory credit score.

One trade group and several comments expressed concern that SBA may impose a minimum credit score requirement and argued that traditional underwriting can overcome the reasons that an applicant or individual may have a low credit score. Other comments stated that lenders who continue to fully underwrite their loans will be on an uneven playing ground versus those lenders that rely on credit scoring models. These commenters stated that traditional comprehensive credit underwriting is more reliable than credit scoring models. Some of the comments in support of the revisions stated the proposed rule will allow SBA to fully leverage the process, skillset and experience of participating lenders without constraining them with SBA-specific lending criteria and will align lender processes for guaranteed and non-guaranteed loans. SBA did not propose to include a requirement for a minimum credit score in the proposed rule. SBA has historically provided lenders with an alternative underwriting path that may be used to fully underwrite a loan where the applicant has an unacceptable credit score, see for example, the 7(a) Small Loan delivery method and the Community Advantage Pilot Program. SBA considered the comments regarding traditional credit underwriting being more reliable; however, technological advances and modeling are providing more accurate methods of calculating risk, and lenders employing these measures are better able to provide small businesses access to capital, especially those businesses owned by underserved communities. The revisions provide options to SBA Lenders that incorporate the use of modern underwriting tools currently employed in the lending industry.

*Section 120.160—Loan Conditions*

Current § 120.160(c) states that for 7(a) and 504 loans SBA requires hazard insurance on all collateral and does not distinguish this requirement by loan size. SBA

has determined that the hazard insurance requirement can be burdensome for the smallest businesses borrowing the smallest amount of money. SBA proposed to modify the requirement for hazard insurance for all 7(a) and 504 loans \$150,000 and under to create flexibility for SBA Lenders. SBA proposed to include guidance in the Loan Program Requirements for loans of \$150,000 or under that SBA Lenders must follow the hazard insurance policies and procedures they have established and implemented for their similarly-sized, non-SBA-guaranteed commercial loans. For all loans greater than \$150,000, SBA stated it will continue to require hazard insurance on all collateral. SBA Lenders must continue ensuring that borrowers obtain flood insurance per § 120.170 when required under the Flood Disaster Protection Act of 1973 (Sec. 205(b) of Public Law 93-234; 87 Stat. 983 (42 U.S.C. 4000 et seq.)).

SBA received 43 comments on the proposed revision. Thirty-eight comments supported the proposed change as-is or supported the change with some modifications, and five comments opposed the proposed change. Some comments stated that regardless of loan amount, hazard insurance should be required to mitigate risk for all loans, or for all loans where real estate or improved real estate is collateral, or for all loans where equipment is being purchased with loan proceeds. Other comments stated that \$150,000 as a threshold is too low, and suggested the threshold should be set at \$500,000, because even with hazard insurance in place, the lender and/or SBA's recovery on assets in this dollar range is minimal after the costs of liquidation and litigation are considered. SBA agrees with the comments that state the threshold for requiring hazard insurance should be set at a higher level. Therefore, SBA is revising the rule to require hazard insurance for collateral on 7(a) loans greater than \$500,000 and 504 projects greater than \$500,000. SBA will include guidance in the Loan Program Requirements for loans of \$500,000 or under that SBA Lenders must follow the hazard insurance policies and procedures they

have established and implemented for their similarly sized, non-SBA-guaranteed commercial loans.

Some comments expressed concern that SBA would not honor a guaranty purchase request if an event such as a fire caused a borrower to default on a loan. SBA would not cite lack of hazard insurance as a reason to deny a guaranty purchase request if the SBA Lender was acting in accordance with Loan Program Requirements. For example, in the scenario where a loan is \$500,000 or under and the use of proceeds is for working capital, and the lender's policy for similarly-sized, non-SBA guaranteed loans is that it does not require hazard insurance for working capital loans, if a calamitous event such as a fire occurs and the borrower defaults on the loan because it is unable to resume business due to a lack of hazard insurance, SBA would not cite lack of hazard insurance as a reason to deny the guaranty purchase request. Other comments supported requiring lenders to follow their own hazard insurance policy on similarly-sized, non-SBA guaranteed commercial loans, with one comment stating the revision will align lender processes for guaranteed and non-guaranteed loans. For the reasons stated above, SBA is moving forward with the rule applying the \$500,000 threshold.

Some comments, including one from a trade group representing hazard insurance providers, requested that SBA clarify whether the amendment would apply to loans that are already in existence and whether lenders could apply the amendment to a loan once the outstanding balance is paid down to the \$150,000 threshold. SBA will provide further guidance in its Loan Program Requirements. Some of these comments requested that SBA make further changes to its requirements for flood insurance, which is outside the scope of the rule.

*Section 120.193—Reconsideration after denial*

Under current § 120.193, the process for reconsideration after denial of a loan application or loan modification request in the 7(a) and 504 Loan Programs states that

final reconsideration is made by the Director of the Office of Financial Assistance. To facilitate fair and expeditious reconsiderations, SBA is revising this regulation to state that the Director of the Office of Financial Assistance or the Director's designee(s) may make the final decision on reconsideration. From time to time, SBA may change the designee(s) and would do so in accordance with published Delegations of Authority. Further, SBA is revising this regulation to provide the Administrator with the authority, solely within the Administrator's discretion, to review a reconsideration request and make the final Agency decision. Finally, SBA is revising this regulation to state that the Administrator's discretionary authority does not create any additional appeal rights for the applicant that are not otherwise specified in regulation.

SBA received 34 comments on the proposed rule change. Twenty-one comments supported the proposed rule as-is, and eight comments supported the rule but requested modifications. Most of the comments requesting modification supported allowing the Director to designate a career employee (such as the Chiefs of 7(a) or 504 Loan Policy) to make the final Agency decision but opposed allowing the Administrator to make the final Agency decision for fear that this would politicize decision making. Five comments opposed any delegation because they stated the decision-making authority should stay with the Director. Other comments stated SBA should expand the delegation of authority to include servicing actions. For the reasons stated above, SBA is moving forward with the rule to permit the delegation of Authorities.

*Section 120.202 – Restrictions on loans for changes of ownership.*

Current § 120.202 restricts borrowers from using 7(a) loan proceeds to purchase a portion of a business or a portion of another owner's interest. SBA is revising this section to allow borrowers to use 7(a) loan proceeds to fund partial changes of ownership in addition to full changes of ownership. The revision will allow a borrower to purchase a portion of the business or a portion of an owner's interest in a business, or to purchase the

entire business or an owner's entire interest. A borrower could also purchase the partial or entire interests of multiple owners. This revision will allow borrowers to use 7(a) loan proceeds to fund partial changes of ownership and will help provide employees a path to ownership.

SBA received 48 comments regarding the proposed changes to §§ 120.130 and 120.202 to permit partial changes of ownership, including 15 comments supporting the proposal as-is and another 17 comments, including one from a trade group, supporting the proposal and requesting that the 504 Loan Program also be permitted to fund partial changes of ownership. The 504 Loan Program only permits loans for a change of ownership when the 504 project finances only the costs associated with eligible long-term fixed assets. As stated in §§ 120.801(c) and 120.934, generally, permanent financing of the Project consists of a loan made with the proceeds of a CDC Debenture for up to 40 percent of the Project costs collateralized by a second lien on the Project Property, and a Third Party Loan with a first lien position. The debentures are then sold to investors that expect the debenture to be secured by a second lien position on collateral. The success of the 504 Loan Program is dependent on investors being willing to purchase these debentures. Loans for partial changes of ownership will generally have collateral and collateral lien positions that are incompatible with the debenture sale process. Amending the 504 Loan Program to permit 504 loans to fund partial changes of ownership is outside the scope of the rule.

One trade group appeared to be neutral as to whether SBA should implement the proposed change, but stated if SBA moves forward with this proposal, SBA should state clearly that 7(a) funds may not be used for investment purposes. It should be noted that SBA already has a regulation at § 120.130(d) that states SBA will not authorize nor may a borrower use loan proceeds for the purpose (including the replacement of funds used for any such purpose) of investments in real or personal property acquired and held

primarily for sale, lease, or investment (except for a loan to an Eligible Passive Company or to a small contractor under § 120.310).

The remaining 15 comments opposed the amendment. One trade group stated the principle underlying the current prohibition against distributing proceeds of a 7(a) loan to an associate of the applicant business protects against sham transactions where an individual personally receives 7(a) loan proceeds while continuing to play a key role in the operations of the business. One comment expressed opposition to the rule, stating that a loan for the purpose of a partial change of ownership is by its very nature a personal loan, not a business loan. One of the examples provided in one of the comments was a business with three owners, where one of the owners wishes to retire and only one of the remaining owners wishes to purchase the outgoing owner's portion of the business. The comment stated there is no benefit to the third owner that was remaining on as owner of the business but that was not purchasing the outgoing owner's portion of the business. However, since SBA's Standard Operating Procedure 50 10 6 went into effect on October 1, 2020, SBA has permitted one or more current owners to purchase the entire interest of another current owner, resulting in 100 percent ownership of the business by the remaining owners; in this type of change of ownership, the small business and the individual owner(s) who is acquiring the ownership interest must be co-borrowers while the remaining owner(s) remain unaffected. The same comment expressed the concern that the lien may not be properly perfected. SBA's Loan Program Requirements currently address adequacy of collateral, including loans for changes of ownership between existing owners, working capital, purchase of stock, and intangible assets such as good will. SBA will provide guidance on adequacy of collateral for loans for partial changes of ownership in its Loan Program Requirements and lender outreach activities. The same comment provided alternative solutions for ensuring the success of changes of ownership,

including some already under consideration in the proposed rule, such as allowing greater flexibility in equity requirements in § 120.150.

Several comments requested clarifying information that SBA will include in Loan Program Requirements and in lender outreach, including training events. For example, several comments asked whether sellers would be allowed to remain as employees in a complete or partial change of ownership. Some of these comments stated that allowing the seller to remain in place, either as a part owner or employee, will allow the seller to provide guidance and expertise to ensure the success of the business. For a complete change of ownership, SBA's Loan Program Requirements currently permit the seller to remain as an officer, director, stockholder or Key Employee of the business for a period not to exceed 12 months, and SBA also currently permits a seller to remain as an employee indefinitely in the rare circumstance when the seller will not be an officer, director, stockholder or Key Employee of the business. For partial changes of ownership, SBA intends to allow the selling owner to remain as an owner and involved in the day to day business, including as an officer, director, Key Employee, or employee.

Some comments inquired whether the partial change of ownership would be treated similarly to a stock purchase transaction where both the individual purchasing ownership and the business entity are required to be co-borrowers on the loan. SBA will require the business to be the borrower or co-borrower with any entity purchasing a partial interest. SBA will provide further guidance on these and other questions in its Loan Program Requirements and lender outreach activities.

As described above, SBA received comments on section 120.130(a), which currently prohibits payments, distributions, or loans to associates of the applicant (except for ordinary compensation for services rendered). These comments pointed out that in order to facilitate the use of 7(a) loan proceeds to be used for partial changes of ownership, section 120.130 paragraph (a) would also need to be modified to permit

payments, distributions, or loans to associates of the applicant. SBA had already addressed the prohibition in § 120.130(a) that prohibits payments, distributions, or loans to associates of the applicant by the proposed revision to § 120.202, which, as proposed, would state: “Notwithstanding § 120.130(a), a Borrower may use 7(a) loan proceeds to purchase a portion of or the entirety of an owner’s interest in a business, or a partial or full purchase of a business itself.” However, the comments make it clear that there would be some confusion in interpreting the proposed revisions to §§ 120.130 and 120.202 regarding restrictions on uses of proceeds for partial changes of ownership. Accordingly, SBA is revising § 120.130, paragraph (a) for clarity as stated above, and is revising the proposed revision to § 120.202 to delete the introductory phrase “Notwithstanding § 120.130(a)”.

*Section 121.301—What size standards and affiliation principles are applicable to financial assistance programs?*

Section 121.301 states the size standards and affiliation principles that are applicable to SBA’s financial assistance programs. Paragraph (f) details how affiliation principles are applied for the 7(a) Loan Program, the 504 Loan Program, the Microloan Program, the ILP Program, the Business Disaster Loan Programs (except for the COVID EIDL Disaster Loan Program),<sup>1</sup> and the SBG Program. This paragraph currently has seven sub-paragraphs, each of which details a separate affiliation principle that must be applied to the applicant and other entities to determine whether the entities are affiliated. The determination of affiliation is necessary to ensure that an applicant is “small” for purposes of eligibility for SBA financial assistance and to ensure that the applicant (including affiliates) does not exceed the maximum guaranty amount available. Currently, paragraphs (f)(1) through (f)(7) consider: (1) affiliation based on ownership,

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<sup>1</sup> The affiliation principles for the COVID EIDL Disaster Loan Program are contained in paragraph (g) of Section 121.301.

including the principle of control of one entity over another; (2) affiliation arising under stock options, convertible securities, and agreements to merge, including the principle of control of one entity over another; (3) affiliation based on management, including the principle of control of one entity over another; (4) affiliation based on identity of interest between close relatives; (5) affiliation based on franchise and license agreements, including the principle of control of one entity over another; (6) determining the concern's size; and (7) exceptions to affiliation.

SBA is revising § 121.301 affiliation provisions to simplify the program requirements, streamline the application process for SBA's programs, and facilitate the review of such applications. SBA is specifically removing the principle of control of one entity over another as a separate basis for finding affiliation because the concept of control as it exists requires understanding and expert consideration of business entity relationships well beyond what is owned by the applicant business or its owners. These considerations are complex and require judgement calls that confuse and unnecessarily burden small business applicants and lenders, and ultimately result in inconsistent application of this concept. For example, determining whether an entity has control over another requires in-depth analyses of the contractual relationships an applicant may have, including relationships established by franchise, license, and management agreements deemed necessary and appropriate by an independent small business owner to operate. The determination of whether one or more managers hired to assist the applicant small business have control over the business, and further requiring review of the business type and business ownership of family members who may be deemed affiliates based on NAICS code and proximity to the applicant increases costs, delays application processing, and/or prevents an otherwise eligible small business from receiving support. SBA instead believes that affiliation based on ownership is the customary basis for considering who is deemed to control a business. Accordingly, SBA has determined that

issues of control and familial relationships as separate bases for finding affiliation are not necessary.

SBA is revising § 121.301 to add an introductory paragraph at the beginning to include the Small Business Act definition of a small business concern as one which is independently owned and operated, and which is not dominant in its field of operation. SBA interprets this statutory definition to require, in certain circumstances, the inclusion of other entities (“Affiliates”) owned by the applicant or an owner of the applicant in determining the size of the applicant. SBA is revising § 121.301(f)(1), “Ownership,” to remove the principle of control of one entity over another absent ownership over that entity when determining affiliation. SBA is expanding upon the definition of “ownership” under paragraph (f)(1) to clarify the thresholds of ownership at which SBA considers an applicant to be affiliated with an individual or another business. SBA is also clarifying that certain instances of affiliation by ownership will only arise if the applicant and another business operate in the same three-digit NAICS subsector to restrict affiliates to businesses in the same field. Paragraph (f)(1)(i) will state that businesses in which the applicant is a majority owner are affiliates of the applicant. Paragraph (f)(1)(ii) describes affiliation with businesses that own a majority of the applicant as well as businesses in the same three-digit NAICS subsector that are majority-owned by the applicant’s owner. Paragraph (f)(1)(iii) describes affiliation with another business when the applicant and the other business are both majority-owned by the same individual and operate in the same three-digit NAICS subsector. Paragraph (f)(1)(iv) describes a 20 percent threshold of ownership for affiliation with the applicant when the applicant does not have a majority owner if a 20 percent owner also operates in the same three-digit NAICS subsector as the applicant. Paragraph (f)(1)(v) will state that if the applicant does not have a majority owner and an individual owns 20 percent or more of the applicant, businesses that are majority-owned by that owner and operate in the same three-digit

NAICS subsector will be affiliates of the applicant. Paragraph (f)(1)(vi) will state that ownership interests of spouses and minor children will be combined when determining ownership interest (as interests may be held in trust by parents for minors). Finally, SBA is revising Paragraph (f)(1)(vii) to state that SBA will analyze the pro rata ownership of entities to determine affiliation and provide an example of the combined interest of an individual and an entity that is wholly-owned by the same individual.

Because SBA is revising its regulation generally by removing the principle of control of one entity over another as a separate basis for finding affiliation, SBA is also revising § 121.301(f)(2), “Stock options, convertible securities, and agreements to merge,” paragraphs (f)(2)(i) and (iv). Where paragraph (f)(2)(i) currently states that SBA considers stock options, convertible securities, and agreements to merge (including agreements in principle) to have a present effect on the power to control a concern, the revised paragraph (f)(2)(i) will state that, for purposes of that paragraph, the items will have a present effect on ownership of the entity. SBA is revising paragraph (f)(2)(iv) by deleting the first sentence where SBA currently states SBA will consider whether an individual, concern or other entity that controls one or more other concerns cannot use options, convertible securities, or agreements to appear to terminate such control before actually doing so. SBA is removing the first sentence of paragraph (f)(2)(iv) because it is unnecessary; the remaining sentence of the paragraph clearly states that SBA will not give present effect to the ability of an entity to divest in the future to avoid a finding of ownership.

SBA is removing paragraph (f)(3), affiliation based on management, because SBA is revising its regulation generally by removing the principle of control of one entity over another without ownership from consideration of affiliation. SBA believes it should not interfere in a business owner’s right to enter into a service agreement with a

management company. The decision to hire a management company is the sole responsibility of the independent business owner(s).

SBA is also removing paragraph (f)(4), affiliation based on identity of interest, because SBA believes it is inherently unfair and inappropriate to require close relatives that do not have an ownership interest in the applicant to provide financial statements for review by a lender and by SBA in determining the size of the applicant business. For example, the current rule requires a sole proprietor who is requesting an SBA direct or guaranteed loan to provide their sibling's business's financial statements for review when the sibling is in the same or similar industry in the same geographic area. SBA believes this requirement imposes a chilling effect on applicants that may be forced to consider alternative predatory lending sources because relatives bear no legal responsibility to disclose their business financial statements for transactions in which they have no ownership interest. However, as stated above, SBA is combining the ownership interests of spouses and minor children when determining affiliation by ownership.

SBA is removing paragraph (f)(5), affiliation based on franchise and license agreements. Because SBA is removing the principle of control of one entity over another from its affiliation consideration, this paragraph is no longer needed. Upon the effective date of this rule, SBA will no longer publish the SBA Franchise Directory.

As is the requirement for all loans, SBA Lenders will continue to be required to examine Franchised businesses for affiliation based on ownership. For example, when lending to a Franchised business, the SBA Lender must determine who owns the applicant business and any businesses the applicant owns in accordance with these regulations. However, neither the SBA Lender nor SBA will review the applicant Franchised business for affiliation with other entities beyond ownership; the applicant business will not be considered affiliated with the Franchisor or other Franchised businesses except by ownership.

SBA received 54 comments on the proposed revisions of § 121.301, paragraph (f). Twelve comments expressed overall support for the proposed rule. Thirty-four comments requested modifications to the proposed rule, with the most frequent comment expressing opposition to no longer publishing an SBA Franchise Directory. The remaining eight comments expressed general opposition.

One comment expressed support of all proposed affiliation changes, but asked how lenders would determine if a business is dominant in its field of operation. This comment is referencing the introductory paragraph that SBA is adding to § 121.301 that includes the Small Business Act definition of a small business concern as one which is independently owned and operated, and not dominant in its field of operation. This introductory paragraph was added to help frame the requirements at § 121.301(f). SBA interprets the statutory definition of a small business concern as requiring, in certain circumstances, the inclusion of other entities known as Affiliates that are owned by the applicant or an owner of the applicant in determining the size of the applicant.

Several comments stated support of the overall revisions to § 121.301 but objected to the inclusion of NAICS codes in the proposed rule for § 121.301(f)(1)(ii) through (v). One comment stated that SBA Lenders use affiliation as a guide to determine which entities to analyze for credit purposes and that removing industries outside of an applicant's NAICS code will skew the SBA Lender's analysis. However, SBA provides the criteria for lenders to underwrite loans in § 120.150. SBA Lenders have historically and will continue to be required to follow the regulation at § 120.150 when analyzing a loan for credit purposes.

A trade group expressed concerns that the proposed amendments may result in larger, more complex, and more sophisticated business structures qualifying for multiple SBA-guaranteed loans. The trade group stated that it does not oppose the proposed change regarding ownership thresholds. However, the trade group also stated it does not

concur with removing control as part of the consideration of whether two entities are affiliated. The comment stated the existing regulatory requirements for control should continue because they believe both common ownership and common control are essential factors in determining whether a small business operates on an independent basis.

Regarding the proposed change to paragraph (f)(1)(vii), one comment stated that when multiple business entities own an applicant business, and when the entity owners are owned by entity owners, it can be difficult to trace back to the natural person to determine percentage of ownership. Currently, SBA requires this disclosure of the applicant owners to identify which owners are required under the 20 percent ownership rule to guarantee a loan. The inclusion of this information in the Final Rule merely codifies what is currently a program requirement. The vast majority of SBA loans are made to businesses with a simple ownership structure, and the existence of a very small percentage of applicants with a complex ownership structure as compared to SBA's overall business loan portfolio is not a compelling reason to remove the requirement from this final rule.

One comment stated that the revisions will cause all Eligible Passive Companies (EPCs) and Operating Companies (OCs) to be unaffiliated. While the ownership of an EPC may be different from the OC, the EPC's sole purpose is to hold assets for the benefit of an eligible OC that is the qualifying entity on which cash flow and repayment of the loan is based. The OC is required to be a co-borrower or guarantor on any loan to an EPC.

Regarding the proposed change to paragraph (f)(3), affiliation based on management, SBA received ten comments, with six comments supporting the change as-is, three comments opposing the change, and one comment requesting clarification. Those that opposed the change, including a trade group, stated that this would allow SBA loan proceeds to fund investors that would passively manage businesses. However, as

stated above, SBA already has a regulatory prohibition on funding investors at § 120.130, which states SBA will not authorize nor may a borrower use loan proceeds for the purposes (including the replacement of funds used for any such purpose) of investments in real or personal property acquired and held primarily for sale, lease, or investment.

Regarding the proposed change at § 121.301(f)(4), affiliation based on identity of interest, there was nearly universal support for this change, except for one comment that opposed the proposed revision, stating repeal of the identity of interest rule is an overcompensation by SBA that will open the program to abuse by unscrupulous borrowers and unwitting lenders. SBA does not agree with this concern.

Most of the comments that opposed the revisions to § 121.301 were focused on the removal of paragraph(f)(5), affiliation based on franchise and license agreements and specifically opposed SBA's intention to no longer publish an SBA Franchise Directory while requiring SBA Lenders to retain the responsibility for ensuring that the applicant meets all Loan Program Requirements, including but not limited to obtaining proper lien position on collateral and ensuring the applicant does not have discriminatory hiring practices. Of the 53 comments that directly addressed the proposed changes to § 121.301(f)(5), only four comments supported the proposal as-is with the remainder expressing opposition to the proposed change mainly on the grounds that they opposed discontinuance of an SBA Franchise Directory.

The general concern was that lenders would be required to determine franchise eligibility. If SBA were to discontinue publishing a franchise directory without modifying the current affiliation rules, SBA agrees that SBA would be transferring the responsibility for determining affiliation based on control to lenders. However, the comments did not take into consideration the fact that SBA is removing as part of this rule the concept of affiliation based on control, including control by a Franchisor of a franchisee's business. In point of fact, as a result of this rule, SBA will update Standard Operating Procedure 50

10, Lender and Development Company Loan Programs, by deleting Part 2, Section A, Chapter 1, Paragraph D. 6, Affiliation Based on Franchise, License, Dealer, Jobber, and Similar Agreements, and eliminate SBA's Addendum to Franchise Agreement and its process identified therein. SBA has determined that franchise business models would not be made ineligible for SBA business loans based on § 120.110, which states the businesses that are ineligible for SBA business loans. For example, ineligible businesses include, among others, non-profit organizations, life insurance companies, government entities, speculative businesses (such as wildcatting), use of proceeds for stock and real estate speculation, passive businesses, and prurient businesses.

SBA Lenders must evaluate all applicants for eligibility and must ensure proper lien position on all loans, regardless of whether the applicant is a franchise or non-franchise business. Under the current rules, if SBA determines the franchisor exercises excess control over the franchisee, SBA will consider the franchisor and franchisee to be affiliated, which in most cases would mean the applicant would not be eligible for an SBA loan because it would not meet SBA's size standards. The purpose for publishing an SBA Franchise Directory was to prevent SBA Lenders and SBA from repeatedly reviewing the same franchise documents for the issue of excessive control. Because SBA was already reviewing the franchise documents for the issue of excessive control, SBA also reviewed the franchise documents for other business model eligibility requirements that apply to all applicants, including non-franchisee applicants, such as non-discriminatory hiring practices and providing the applicant purchaser the right to encumber the applicant's property with liens. These revisions remove the principle of control of one entity over another from consideration of affiliation; therefore, the mere fact that an applicant may be a franchisee is not in itself a reason that would render the applicant ineligible for an SBA loan, and thus there is no longer a compelling reason to maintain the SBA Franchise Directory. Additionally, the mere fact that a franchise is

listed on the SBA Franchise Directory does not, under current policies nor under the proposed policies, relieve the SBA Lender from determining whether the applicant meets all eligibility and other Loan Program Requirements, including but not limited to; certifying that the applicant does not have the ability to obtain some or all of the requested loan funds on reasonable terms from non-Federal, non-State, or non-local government sources, ensuring that applicants are U.S. citizens or Legal Permanent Residents and that the applicant business is located in the United States, obtaining personal and corporate guaranties, confirming that the applicant business has the ability to repay the loan through cash flow of the business, has eligible uses of proceeds, verifying financial information, obtaining proper collateral and lien position, determining whether there is a direct or indirect impact on historic properties, compliance with environmental policies and procedures, and closing the loan in accordance with SBA program requirements.

One comment stated that SBA's review of franchise documents for excess control by the franchisor has led to indirect benefits for franchisees, which "resulted in significant improvements in franchise lending" providing greater assurance that the franchisee has the right to profit from their efforts and that the franchisor would not impose objectionable terms such as approvals on changes of ownership, forced sale of assets, restrictive covenants on real estate, and control of employees. While SBA appreciates this perceived indirect benefit, SBA maintains that it is solely an applicant's business decision whether it wishes to operate as a franchise or non-franchise business. All purchase agreements, even purchase agreements of non-franchise businesses, may potentially include these terms that the comment describes as objectionable, and it is incumbent on all parties to fully understand the terms of any contract they sign. Further, SBA does not have the statutory authority to act as a regulator of franchises, only guarantees a small percentage of loans to franchisees relative to the number of franchise

businesses that are started and operate in the U.S., and only uses the Federal Trade Commission definition of franchise in SBA's policies and procedures. For the reasons stated above, SBA is moving forward with the rule as proposed.

**Compliance with Executive Orders 12866, 12988, 13132, and 13563, the Paperwork Reduction Act (44 U.S.C., Ch. 35), the Congressional Review Act (5 U.S.C. 801–808), and the Regulatory Flexibility Act (5 U.S.C. 601-612)**

*Executive Order 12866*

The Office of Management and Budget has determined that this rule is a “significant regulatory action” under Executive Order 12866. SBA performed a comprehensive Regulatory Impact Analysis in the proposed rule for the public’s information. Because SBA is not substantially changing any of the proposed amendments, the final analysis is unchanged and is synopsized below. Each section begins with a core question.

A. Regulatory Objective of the Proposal

Is there a need for this regulatory action?

SBA performed a comprehensive cost benefit analysis in the proposed rule. SBA is moving forward with only minor adjustments that will not have a significant impact on the cost benefit analysis that was published in the proposed rule; therefore, the cost benefit analysis is updated where appropriate or synopsized below.

The Agency believes it needs to streamline and reduce regulatory burdens to facilitate robust participation in the business loan programs that assist small and underserved U.S. businesses and the disaster loan programs that assist businesses of all sizes with recovery from disasters.

Regarding modernization of lending criteria, as a result of the emergency lending programs mandated to address economic impacts of the pandemic, SBA significantly leveraged the use of technology in loan delivery to capture efficiencies that can be

applied across programs to increase access and lower costs for both participating lenders and the public. SBA also understands that lenders are currently leveraging data analytics tools and machine learning modelling in their conventional lending criteria models, particularly for small dollar loans, and that by modernizing SBA's lending criteria to match lending practices already being implemented by its participating lenders, SBA will encourage more lender participation in its programs. For these reasons, among others, SBA is moving forward with the changes to SBA's lending criteria rules at 13 CFR 120.150.

By dispensing with the requirement for hazard insurance for all 7(a) and 504 loans of \$500,000 or less, SBA will eliminate a burdensome regulatory requirement for small loans while providing SBA Lenders with the flexibility to use their own policies for similarly-sized non-SBA guaranteed loans regarding hazard insurance on these loans.

By permitting the Director, Office of Financial Assistance, to delegate reconsideration requests to a designee, SBA will facilitate fair and expeditious review of reconsideration requests and provide finality to applicants that are in the process of making important financial decisions.

SBA is revising its affiliation regulations in response to continuing requests by SBA's participating lenders and the public. SBA believes that revising its affiliation regulations will result in expansion of credit to those who cannot obtain credit elsewhere and increased understanding of and compliance with program rules while decreasing time spent reviewing an applicant for eligibility.

There is also a need for SBA to address financing for changes of ownership. Orderly transitions of business ownership are beneficial both to the small business and its employees. Employees acquiring partial ownership interest in small businesses assists with transitions of ownership, especially when there is more than one current owner and one of the current owners intends to sell their equity stake in the small business to one or

more employees who may not have an equity ownership interest at that time. The small business benefits by remaining in operation when it might otherwise be forced to close, and the employees benefit by having a path to ownership in a small business that remains in operation. Partial changes of ownership among existing owners of a small business permit such businesses to attract new employees as partial owners. Financing for changes of ownership also allows family members to purchase partial ownership in a family-run small business to ensure continuation of the small business after the retirement or death of an owner. Currently, SBA does not fully meet the financing needs of small businesses regarding partial changes of ownership due to current restrictions, necessitating this rule.

Historically, SBA has permitted loan proceeds for use only in three situations involving a change of ownership: 1) A complete change of ownership; 2) a Partner Buyout; and 3) where an ESOP purchases a controlling interest (51 percent or more) in the employer small business from the current owner(s). Outside of loans to ESOPs, SBA's current regulations do not permit 7(a) loan proceeds to be used for partial changes of ownership.

Over the past 4 completed fiscal years (FY 2018 through FY 2021), SBA approved 31,940 7(a) loans where loan proceeds were used to affect a change of ownership. ESOP loans (loans to assist an ESOP trust in acquiring 51 percent or more of the equity ownership in the small business concern) accounted for only 17 of the 31,940 loans used for a change of ownership in the four years between FY 2018 and FY 2021, or fewer than five loans per year. Therefore, ESOP loans have not made the anticipated impact in transitioning small businesses to employee ownership as originally intended by the Agency. For these reasons, SBA is moving forward with lifting the prohibition on partial changes of ownership. SBA will include detailed guidance in the Loan Program Requirements to accomplish partial changes of ownership.

The changes will reduce regulatory burdens, modernize program delivery using data analytics tools and machine learning modelling, reduce the number of hours spent processing an application to deliver a loan for both SBA and lenders and increase access to capital.

#### B. Benefits and Costs of the Rule

What are the potential benefits and costs of this regulatory action?

SBA does not anticipate significant additional costs or impact on the subsidy to operate the 7(a), 504, Microloan, ILP, SBG and Business Disaster Loan Programs under these revisions to the regulations.

SBA anticipates a minor impact to the subsidy as a result of approximately 800 new loans per year in 7(a) loan activity for loans involving a partial change of ownership. In revising SBA's lending criteria at 13 CFR 120.150, SBA anticipates that modernizing SBA's lending criteria to include credit scoring will not compromise the credit quality of the overall 7(a) and 504 portfolios. When using a credit scoring model other than the FICO® Small Business Scoring Service<sup>SM</sup> (SBSS) model, SBA Lenders must be able to validate the credit scoring model and must document that their credit analysis procedures are predictive of loan performance; therefore, no reduction in credit quality is anticipated as a result of using credit scoring models. Streamlining the number of criteria lenders consider when approving loans, and for regulated lenders, using the same commercial credit analysis processes and procedures consistent with those used for their similarly-sized, non-SBA guaranteed commercial loans will not negatively impact the credit quality of the 7(a) and 504 Loan Program portfolios and will provide a time saving ranging from zero to several hours per loan depending on the size and complexity of the loan. SBA anticipates that modernizing SBA's lending criteria and allowing SBA Lenders to use their own processes and procedures will result in an increase in the

number of participating lenders and loans in both programs, which would mean increased access to capital for small businesses.

The primary goal driving the revisions to 13 CFR 120.150 is to encourage and facilitate more lenders to make more small dollar loans. SBA believes these streamlined rules will result in increased lender participation, particularly for community banks, credit unions and other mission-based lenders that generally serve more rural communities and underserved populations with smaller dollar loans.

By revising 13 CFR 120.160 to state that SBA requires hazard insurance only for loans greater than \$500,000, SBA anticipates a de minimis impact on annual subsidy calculation for the 7(a) and 504 Loan Programs. The primary benefit to removing the requirement for hazard insurance on these small loans is to increase the speed with which lenders can disburse loan proceeds after loan approval. Hazard insurance is only impactful when it is protecting collateral. Currently, SBA does not require collateral for loans \$25,000 or less, so these loans are not impacted by the revision to hazard insurance requirements. Further, lenders will continue to require hazard insurance for loans of \$500,000 and under when tangible assets such as real estate or equipment are financed with the loan in accordance with their non-SBA guaranteed policies and federal regulators. As such, although lenders will continue to require hazard insurance in accordance with their similarly-sized non-SBA guaranteed policies, they will experience a time savings by no longer providing SBA with documentation of proof of hazard insurance as part of SBA's loan origination and monitoring requirements. Further, even with hazard insurance in place, the lender and/or SBA's recovery on assets in this dollar range is minimal after the costs of liquidation and litigation are considered. The benefit to SBA for requiring hazard insurance at this amount is minimal, while lenders will save time and be able to disburse loan proceeds more quickly after loan approval by using

their own procedures and not having to provide additional documentation evidencing insurance to SBA.

Revising 13 CFR 120.193 will allow the Director of the Office of Financial Assistance to delegate to a designee the authority to make final decisions on reconsideration after denial of a loan application or loan modification request in the 7(a) and 504 Loan Programs. SBA does not anticipate any additional costs or impact on the subsidy to operate the 7(a) and 504 Loan Programs under this final rule. Additionally, the number of loans impacted by this change is very low in comparison to the number of loans processed in both loan programs. On average, the 7(a) Loan Program accounts for 10 to 12 reconsideration requests per year, and the 504 Loan Program accounts for 28 to 41 requests per year. For comparison, in fiscal year 2021, the 7(a) Loan Program approved 51,856 loans, and the 504 Loan Program approved 9,676 loans. SBA Lenders and applicants will benefit in a faster turn time for decision-making.

SBA does not anticipate significant additional costs or impact on the subsidy to operate the 7(a), 504, Microloan, ILP, SBG and Business Disaster Loan Programs under the revised regulations at 13 CFR 121.301 regarding affiliation. Complex affiliation rules limit accessibility to SBA's business loan programs, with an outsized impact on underserved borrowers who may struggle to access traditional capital or other resources such as attorneys and certified public accountants. SBA anticipates that providing clear and streamlined regulatory guidance for its affiliation rules will result in an increase in the number of participating lenders and loans and will encourage more businesses to apply. SBA anticipates that participating lenders will spend less time screening applicants for eligibility under SBA Size Standards because lenders and applicants will readily be able to determine which entities they are affiliated with, and lenders will have fewer documents to examine.

### C. Alternatives

What alternatives have been considered?

SBA considered eliminating even more regulatory burdens and determined the final rule strikes the right balance in responsibly streamlining regulations without substantially increasing the risk of waste, fraud, or abuse of the programs or otherwise threatening the integrity of the business loan programs or taxpayer dollars. Regarding affiliation, SBA has implemented several variations of its affiliation rules as discussed above, and SBA has determined the simplest affiliation rules were the least burdensome.

SBA also considered limiting partial changes of ownership to employees of the business; however, the Agency believes this may restrict small businesses in need of additional expertise from providing a percentage of ownership as an incentive to recruit and retain new highly skilled employees. For example, an existing dental practice may recruit a new dentist by offering the dentist an equity ownership in the business as a hiring incentive. For this reason, SBA determined that partial changes of ownership should not be exclusive to existing employees of the business.

#### *Executive Order 12988*

This action meets applicable standards set forth in sections 3(a) and 3(b)(2) of Executive Order 12988, Civil Justice Reform, to minimize litigation, eliminate ambiguity, and reduce burden. The action does not have preemptive effect or retroactive effect.

#### *Executive Order 13132*

This rule does not have federalism implications as defined in Executive Order 13132. It will not have substantial direct effects on the States, on the relationship between the national government and the States, or on the distribution of power and responsibilities among the various levels of government, as specified in the Executive Order. As such it does not warrant the preparation of a Federalism Assessment.

#### *Executive Order 13563*

A description of the need for this regulatory action and benefits and costs associated with this action, including possible distributional impacts that relate to Executive Order 13563, are included above in the Regulatory Impact Analysis under Executive Order 12866.

*Paperwork Reduction Act, 44 U.S.C. Ch. 35*

SBA has determined that this rule will require that the following forms be revised: SBA Form 1919, "Borrower Information Form," SBA Form 1920, "Lender's Application for Loan Guaranty for all 7(a) Loan Programs," SBA Form 1244, "Application for Section 504 Loans," SBA Form 5 – Disaster Business Loan Application, and SBA Form 5C – Disaster Home/Sole Proprietor Loan Application.

SBA Forms 1919 and 1920 are approved under OMB Control number 3245-0348. SBA Form 1244 is approved under OMB Control number 3245-0071. SBA Form 5 is approved under OMB Control number 3245-0017 and SBA Form 5C is approved under OMB Control number 3245-0018.

SBA will revise SBA Form 1919, SBA Form 1920, and SBA Form 1244 to conform to the lending criteria changes at 13 CFR 120.150. When lenders choose to use a credit scoring model in accordance with 13 CFR 120.150, the estimated hour burden for lenders will decrease when the credit score incorporates consideration of certain lending criteria (e.g., the earnings and cashflow of an applicant), in which case those factors would not necessarily be separately considered by a lender unless otherwise specified by Loan Program Requirements. However, SBA expects that SBA Lenders will make more small dollar loans due to the ability to use credit scoring models, which increase the estimated overall burden hours due to the increase in number of loans. This reporting requirement will be included in the OMB information collection submissions for the affected forms. The other revisions to 120.150 (i.e., requirement that SBA Lenders use appropriate and prudent generally acceptable commercial credit analysis processes and

procedures consistent with those used for their similarly-sized, non-SBA guaranteed commercial loans, and criteria that may be considered in lending criteria), will have a de minimis impact on the estimated hour burden because regulated lenders must comply with more rigorous lending criteria requirements from their federal regulators, and SBA-Supervised Lenders and CDCs must continue to comply with the credit policies submitted to OCRM.

SBA will revise SBA Form 1920 to conform to revisions at 13 CFR 120.130 and 13 CFR 120.202 to permit partial changes of ownership.

SBA will revise SBA Form 1919, SBA Form 1920, SBA Form 1244, and SBA Form 5 to conform to the affiliation rule changes at 13 CFR 121.301, which will reduce the estimated hour burden for applicants and lenders because SBA anticipates fewer entities will fall under the definition of “affiliate.”

SBA will submit these revisions to OMB and provide public notice of such revisions at a later date.

#### *Congressional Review Act, 5 U.S.C. Ch. 8*

Subtitle E of the Small Business Regulatory Enforcement Fairness Act of 1996, also known as the Congressional Review Act or CRA, generally provides that before a rule may take effect, the agency promulgating the rule must submit a rule report, which includes a copy of the rule, to each House of the Congress and to the Comptroller General of the United States. SBA will submit a report containing this rule and other required information to the U.S. Senate, the U.S. House of Representatives, and the Comptroller General of the United States. A major rule under the CRA cannot take effect until 60 days after it is published in the *Federal Register*. The Office of Information and Regulatory Affairs has determined that this rule is not a “major rule” as defined by 5 U.S.C. 804(2). Therefore, this rule is not subject to the 60-day restriction.

#### *Regulatory Flexibility Act, 5 U.S.C. 601- 612*

When an agency issues a rulemaking proposal, the Regulatory Flexibility Act (RFA), 5 U.S.C. 601-612, requires the agency to “prepare and make available for public comment a final regulatory analysis” which will “describe the impact of the final rule on small entities.” SBA published a complete regulatory analysis in the proposed rule. The regulatory analysis is synopsized here. For the reasons stated below, SBA certifies that this rulemaking will not have a significant economic impact on a substantial number of small entities. Although the rulemaking will impact all of the 2,897 7(a) Lenders, all of the 216 CDCs, all of the 150 Microloan Intermediaries, all of the 35 ILP Intermediaries, and all of the 44 Sureties that participate in the SBG Program, SBA does not believe the impact will be significant because this final rule modifies and streamlines existing regulations and procedures. However, there may be impacts due to increased 7(a) loans for partial changes of ownership.

The estimated burden for completing the SBA Form 1919, including time for reviewing instructions, gathering data needed, and completing and reviewing the form remains unchanged at 15 minutes per response. SBA anticipates the revised rules will result in an increase to loan volume by a potential 800 loans per year<sup>2</sup> representing 800 unique small business applicants.

An applicant completing the SBA Form 1919 will spend approximately fifteen minutes per response in completing the form, at a cost of \$23.55 per loan application.<sup>3</sup> The final rules will not change the time costs of completing the revised SBA Form 1919 as the rule changes will not require the applicant small business to provide any additional responses in completing SBA Form 1919 other than those already required.

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<sup>2</sup> The 800 additional loans are due to the revisions allowing for partial changes of ownership.

<sup>3</sup> This estimate was derived from using the median hourly rate for General and Operations Managers from the May 2021 Occupational Employment and Wage Statistics for the United States of \$47.10 per hour, adding 100 percent for overhead and benefits, for a total hourly cost to complete SBA Form 1919 per applicant of \$94.20 per hour. Data available at [https://www.bls.gov/oes/current/oes\\_nat.htm#11-0000](https://www.bls.gov/oes/current/oes_nat.htm#11-0000).

In revising 13 CFR 120.130 and 120.202 to permit partial change of ownership, SBA will update the SBA Form 1920, “Lender’s Application for Loan Guaranty for all 7(a) Loan Programs”, in Section “O”, to add a question for the 7(a) Lender to indicate that the change of ownership is a partial change of ownership, and to revise or combine the second bulleted question in Section O with the new partial ownership question. The current estimated burden for the 7(a) Lender in completing SBA Form 1920, including time for reviewing instructions, gathering data needed, and completing and reviewing the form is 25 minutes per response. Section “O” of SBA Form 1920 is required to be completed in cases involving a change of ownership using the loan proceeds. SBA Form 1920 currently requires the 7(a) Lender to check an “N/A” box if the loan does not finance a change of ownership and answer an additional six “Yes” or “No” questions about the circumstances for the change of ownership. It is anticipated the additional language will be similar in length to the existing questions of approximately 30 words per question, which should add approximately 10 seconds per application to read and respond to the question by checking the yes or no box<sup>4</sup>, which represents a cost increase to lenders of approximately 11 cents per application<sup>5</sup>.

### **13 CFR 120.150, “What are SBA’s lending criteria?”**

Based on industry feedback, SBA estimates SBA Lenders will save anywhere from zero to 2 hours per loan under the revision of 13 CFR 120.150 to require that SBA Lenders must use appropriate and prudent generally acceptable commercial credit analysis processes and procedures consistent with those used for their similarly-sized, non-SBA guaranteed commercial loans. The range in time saving is due to the size and complexity of the loan and federally regulated lenders continuing to underwrite loans in

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<sup>4</sup> The average silent reading rate for adults in English is 238 words per minute, based on an analysis of 190 studies with 18,573 participants by Brysbaert, Marc (April 12, 2019) How many words do we read per minute? A review and meta-analysis of reading rate, page 2, at <https://psyarxiv.com/xynwg/>.

<sup>5</sup> Based on the mean hourly wage of \$38.74 per hour for Loan Officers as of May 2021 U.S. Bureau of Labor Statistics at [https://www.bls.gov/oes/current/oes\\_nat.htm#13-0000](https://www.bls.gov/oes/current/oes_nat.htm#13-0000).

accordance with their own procedures. Based on the average of the most recent 3 fiscal years, each year the 7(a) Loan Program approves 48,687 loans and the 504 Loan Program approves 7,631 loans, for a total of 56,318 loans approved per year. The mean hourly wage of a loan officer is \$36.99 according to the May 2020 U.S. Bureau of Labor Statistics. SBA estimates a cost saving ranging from \$0 to \$2,083,215 per year for SBA Lenders, calculated by multiplying 56,318 (total loans approved per year) by \$36.99 (mean hourly wage of a loan officer). This revision will have no direct impact on applicants and possibly an indirect impact due to faster processing times that could lead to faster loan approval.

SBA anticipates the final rule will allow SBA Lenders to use a credit scoring model will increase the number of small loans approved while generally decreasing the length of time required to process a loan. Not all lenders will use credit scoring, and those that do will limit credit scoring to small loans. SBA estimates lenders will save from 2 to 4 hours per loan when they elect to use a credit scoring model.

**13 CFR 120.160, “Loan conditions.”**

SBA estimates SBA Lenders will save anywhere from 0.25 to 6 hours per loan over the life of the loan under the revision of 13 CFR 120.160 to eliminate the requirement for hazard insurance on loans \$500,000 or less. The range in time saving is due to whether lenders require hazard insurance on similarly-sized non-SBA guaranteed loans in accordance with their own procedures. Lenders that do not require hazard insurance may save up to 6 hours over the life of the loan when including the time required to monitor whether the policy remains in place each year. Lenders that continue requiring insurance will experience a time savings by no longer documenting proof of insurance for SBA.

**13 CFR 120.193, “Reconsideration after denial.”**

The Director of the Office of Financial Assistance processes an average of 10 to 12 reconsideration requests for the 7(a) Loan Program and 28 to 41 reconsideration requests for the 504 Loan Program each year. Revising this rule will have a minimal impact on the overall portfolio; however, to the individual applicants that are impacted by reconsideration requests, a faster decision will allow the applicants to quickly move forward with financing with a positive decision or pursue other financing options with a negative decision.

**Section 121.301, “What size standards and affiliation principles are applicable to financial assistance programs?”**

The revisions to 13 CFR 121.301 will impact all of the approximately 1,738 7(a) Lenders and 186 CDCs that make an SBA loan annually (based on FY 2021 data), all of the approximately 150 Microloan Intermediaries, all of the approximately 44 Sureties that participate in the SBG Program, and all of the applicants for each of these programs and SBA’s Disaster programs. SBA’s revisions to streamline its affiliation rules will increase the overall number of loans made while simultaneously reducing the time required to process each loan.

**List of Subjects**

**13 CFR Part 120**

Loan programs-business, Community development, Reporting and recordkeeping requirements, Small businesses.

**13 CFR Part 121**

Loan programs-business, Reporting and recordkeeping requirements, Small businesses.

For the reasons stated in the preamble, SBA is amending 13 CFR parts 120 and 121 as follows:

**PART 120--BUSINESS LOANS**

1. The authority citation for 13 CFR part 120 continues to read as follows:

**Authority:** 15 U.S.C. 634(b)(6), (b)(7), (b)(14), (h), and note, 636(a), (h) and (m), and note, 636m, 650, 657t, and note, 657u, and note, 687(f), 696(3), and (7), and note, and 697, 697a and e, and note; Public Law 116-260, 134 Stat. 1182.

2. Amend § 120.130 by revising paragraphs (a) and (g) to read as follows:

**§ 120.130 Restrictions on uses of proceeds.**

\* \* \* \* \*

(a) Payments, distributions, or loans to Associates of the applicant (except for ordinary compensation for services rendered or to facilitate changes of ownership in accordance with § 120.202);

\* \* \* \* \*

(g) Any use restricted by §§ 120.201 and 120.884 (specific to 7(a) loans and 504 loans respectively).

3. Revise § 120.150 to read as follows:

**§ 120.150 What are SBA's lending criteria?**

The applicant (including an Operating Company) must be creditworthy. Loans must be so sound as to reasonably assure repayment. Lenders and CDCs must use appropriate and prudent generally acceptable commercial credit analysis processes and procedures consistent with those used for their similarly-sized, non-SBA guaranteed commercial loans. Lenders, CDCs, and SBA may use a business credit scoring model. When approving direct or guaranteed loans, Lenders, CDCs, and SBA may consider (as applicable) the following criteria: credit score or credit history of the applicant (and the Operating Company, if applicable), its Associates and any guarantors; the earnings or cashflow of applicant; or where applicable any equity or collateral of the applicant.

**§ 120.160 [Amended]**

4. In § 120.160 amend paragraph (c) by adding the phrase “for 7(a) loans greater than \$500,000 and for 504 projects greater than \$500,000,” after the words “SBA requires hazard insurance.”

5. Amend § 120.193 by adding the words “or designee(s),” after the words “Director, Office of Financial Assistance (D/FA)” and by adding two sentences at the end of the section to read as follows:

**§ 120.193 Reconsideration after denial.**

\* \* \* If the reconsideration is denied, a second and final reconsideration may be considered by the Director, Office of Financial Assistance (D/FA) or designee(s), whose decision is final. The SBA Administrator, solely within the Administrator’s discretion, may choose to review the matter and make the final decision. Such discretionary authority of the Administrator does not create additional rights of appeal on the part of an applicant not otherwise specified in SBA regulations.

6. Revise § 120.202 to read as follows:

**§ 120.202 Loans for changes of ownership.**

A Borrower may use 7(a) loan proceeds to purchase a portion of or the entirety of an owner’s interest in a business, or a portion of or the entirety of a business itself.

**PART 121--SMALL BUSINESS SIZE REGULATIONS**

7. The authority citation for 13 CFR part 121 is revised to read as follows:

**Authority:** 15 U.S.C. 632, 634(b)(6), 636(a)(36), 662, 694a(9), and 9012.

8. Amend § 121.301 by adding introductory text and by revising paragraph (f) to read as follows:

**§ 121.301 What size standards and affiliation principles are applicable to financial assistance programs?**

The Small Business Act defines a small business concern as one which is independently owned and operated, and which is not dominant in its field of operation.

SBA interprets this statutory definition to require, in certain circumstances, the inclusion of other entities (“Affiliates”) owned by the applicant or an owner of the applicant in determining the size of the applicant.

\* \* \* \* \*

(f) *Affiliation.* Any of the circumstances described below establishes affiliation for applicants of SBA's Business Loan, Disaster Loan, and Surety Bond Programs. For this rule, the Business Loan Programs consist of the 7(a) Loan Program (Direct and Guaranteed Loans), the Microloan Program, the Intermediary Lending Pilot Program, and the Development Company Loan Program (“504 Loan Program”). The Disaster Loan Programs consist of Physical Disaster Business Loans, Economic Injury Disaster Loans, Military Reservist Economic Injury Disaster Loans, and Immediate Disaster Assistance Program loans. The following principles apply for the Business Loan, Disaster Loan, and Surety Bond Guarantee Programs:

(1) *Ownership.* (i) When the Applicant owns more than 50 percent of another business, the Applicant and the other business are affiliated.

(ii) When a business owns more than 50 percent of an Applicant, the business that owns the Applicant is affiliated with the Applicant. Additionally, if the business entity owner that owns more than 50 percent of the Applicant also owns more than 50 percent of another business that operates in the same 3-digit NAICS subsector as the Applicant, then the business entity owner, the other business and the Applicant are all affiliated.

(iii) When an individual owns more than 50 percent of the Applicant and the individual also owns more than 50 percent of another business entity that operates in the same 3-digit NAICS subsector as the Applicant, the Applicant and the individual owner’s other business entity are affiliated.

(iv) When the Applicant does not have an owner that owns more than 50 percent of the Applicant, if an owner of 20 percent or more of the Applicant is a business that

operates in the same 3-digit NAICS subsector as the Applicant, the Applicant and the owner are affiliated.

(v) When the Applicant does not have an owner that owns more than 50 percent of the Applicant, if an owner of 20 percent or more of the Applicant also owns more than 50 percent of another business entity that operates in the same 3-digit NAICS subsector as the Applicant, the Applicant and the owner's other business entity are affiliated.

(vi) Ownership interests of spouses and minor children must be combined when determining amount of ownership interest.

(vii) When determining the percentage of ownership that an individual owns in a business, SBA considers the pro rata ownership of entities. For example, John Smith, Jane Doe, and Jane Doe, Inc., each own an interest in the Applicant. Jane Doe owns 15 percent of the Applicant, and she also owns 100 percent of Jane Doe, Inc. Jane Doe, Inc. owns 50 percent of the Applicant. SBA considers Jane Doe to own 65 percent of the Applicant.

(2) *Stock options, convertible securities, and agreements to merge.* (i) For purposes of this subparagraph, SBA considers stock options, convertible securities, and agreements to merge (including agreements in principle) to have a present effect on the ownership of the entity. SBA treats such options, convertible securities, and agreements as though the rights granted have been exercised.

(ii) Agreements to open or continue negotiations towards the possibility of a merger or a sale of stock at a later date are not considered "agreements in principle" and are thus not given present effect.

(iii) Options, convertible securities, and agreements that are subject to conditions precedent which are incapable of fulfillment, speculative, conjectural, or unenforceable under state or Federal law, or where the probability of the transaction (or exercise of the rights) occurring is shown to be extremely remote, are not given present effect.

(iv) SBA will not give present effect to individuals', concerns', or other entities' ability to divest all or part of their ownership interest to avoid a finding of affiliation.

(3) *Determining the concern's size.* In determining the concern's size, SBA counts the receipts, employees (see § 121.201), or the alternate size standard (if applicable) of the concern whose size is at issue and all of its domestic and foreign affiliates, regardless of whether the affiliates are organized for profit.

(4) *Exceptions to affiliation.* For exceptions to affiliation, see § 121.103(b).

\* \* \* \* \*

Isabella Casillas Guzman,  
*Administrator.*

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